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Morningstar looks at rate cuts, private markets, AI in 2025
By Rob Burgess
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From potential rate cuts to greater access to private markets to the next leap in wealth management AI, many areas of the industry and economy are in flux as 2024 comes to a close.

Morningstar experts shared their insights on what's to come in 2025 during a Dec. 5 webinar on "Investment Strategies for the Year Ahead."

The potential for more rate cuts by the Fed in 2025
Dominic Pappalardo, chief multi-asset strategist for Morningstar, said the Federal Reserve's September rate cut signaled a "regime change." From 2020 until that point, the Fed was in a hiking cycle, mainly to combat the post-pandemic inflation, which reached a level not seen in decades.

"The rather aggressive decision they made to cut by 50 basis points suggests the Fed has gotten quite comfortable that the downward trends in inflation are sustainable and they can move towards easing the burden of that restrictive fiscal policy," he said.

Pappalardo said the September rate cut was also meaningful because it was a drastic move from the monetary authority, a rarity in recent decades.

"The only reductions of this magnitude have been considered emergency cuts occurring during events such as the onset of COVID in March 2020 and before that, all the way back to 2008 during the global financial crisis," he said.

Going forward, Pappalardo said the Fed may be shifting its focus to avoiding undue economic stress by keeping rates too high for too long.

"In other words, they want to preserve the likelihood of achieving their desired soft landing that's been talked about so much," he said. "Recent economic data suggests the economy is still relatively strong compared to where we were in previous easing cycles."

Pappalardo said he believes the Fed will continue to reduce rates into 2025, which theoretically should push all local rates lower. However, the potential caveat is a rebound in inflation or an unforeseen increase in inflation.

"The Fed has proven their No. 1 priority is controlling inflation, and for some reason, consumer price index data starts to move up," he said. "That could change this outlook dramatically, especially long-term. Rates can move higher."

Regular investors will have more access to private assets in 2025
Brian Moriarty, strategist for U.S. fixed income strategies for Morningstar, said there has been a long list of traditional asset managers that have been buying up firms that offer alternative or private asset capabilities, including T. Rowe Price's 2021 acquisition of Oak Hill Advisors.

In October, Capital Group and KKR announced a partnership in which, in 2025, they will launch two interval funds that will offer a mix of public and private credit. In September, State Street Global Advisors and Apollo Global Management partnered to offer private credit ETFs. The same month, BlackRock and Partners Group partnered on a model portfolio solution.

Moriarty said between interval funds, ETFs and model portfolios, "The jury is still out on which of those will be successful."

"Maybe all of them, maybe none of them," he said.

Asset managers are going to compete on offering better products which give regular investors access to strategies and assets that they historically haven't had access to, said Moriarty.

"With the right financial advice that could be a real benefit," he said. "As competition heats up, fees on these solutions will start to come down. That's a story we've seen play out many times over the years."

Moriarty said the risk is that private assets are difficult to trade.

"They're called 'private' for a reason," he said. "Therefore, it's difficult to price them."

How AI will affect investing in 2025
Next year will bring advancements in AI beyond hardware development; instead, the focus will be on how people can utilize it to generate additional revenue or operating margin, said Dave Sekera, senior U.S. market strategist for Morningstar.

Sekera said after the introduction of ChatGPT in November 2022, the next two years saw technology companies building out hardware and software platforms to support AI development.

"There's just been huge amounts of demand, more demand than the amount of supply for everything that's been needed to build these dedicated platforms," he said. "That drove prices through the roof."

The old adage of "selling shovels in a gold rush" certainly applied to hardware providers like Nvidia that have seen unprecedented growth, said Sekera.

"We're now at the point where those hardware suppliers have built out enough

new capacity to be able to better address the amount of forecasted demand," he said. "After spending as much money as they have on AI hardware, I think investors are now looking at the corporations and asking, 'How are they going to be able to utilize all of that capital they've spent over the past two years to generate value?'"

In 2025, Sekera said he expects to see the number of use cases for AI begin to expand rapidly. Some companies will be able to incorporate AI into their existing platforms and build new services. Others will increase efficiency and expand operating margins.

When it comes to the wealth management industry, though, Danielle Labotka, a behavioral scientist for research and investments at Morningstar, said AI is going to give advisors the opportunity to win back valuable time.

"We think that increasing those face-to-face hours with clients can help financial advisors," she said. "We all know that advisors are pressed for time, partly because they have to wear so many different hats. They're not just talking to clients. They're also doing a lot of things behind the scenes, like portfolio construction, compliance and marketing. … But advising, at the end of the day, is a relationship business."

However, Labotka said advisors need to hone their ability to recognize proper uses for AI.

"AI is good at doing things like summarizing material for people or drafting text, but it's not so good at other things that are also really important in financial advising, like critical thinking or taking human perspective," she said. "You want to know what it can do and what it can't do well, but you also want to know what your clients are OK with and what they're not OK with, because if we're seeing generative AI as an opportunity to build better relationships with your clients, you want to make sure that you're not harming the relationship in the process."

In particular, Labotka said clients are sensitive to AI being used by advisors as a "shortcut to sincerity."

"For example, if you use generative AI to create emails to help with scheduling or reminders or maybe even a generic newsletter, it's probably fine," she said. "It's probably something that your clients expect. But if you're doing something like using generative AI to write a personalized bereavement email to a client who just lost their spouse or their parents, that's probably not a good situation to use it in."